Project **Insurance Contracts**

Topic **Scope**

Purpose of this paper

1. This memorandum discusses the scope of a future standard on insurance contracts.

Summary of Staff recommendations

2. The staff recommends that the following contracts should be excluded from the scope of the forthcoming exposure draft on insurance contracts:

    (a) residual value guarantees embedded in a lease;

    (b) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;

    (c) contingent consideration payable or receivable in a business combination.

    [The staff will present scope considerations on financial guarantee contracts and investment contracts with participating features, and health contracts separately, outside this paper.]

3. We note that, as a result of previous decisions in insurance project and decisions in other projects, the following contracts will not be in the scope of the exposure draft on insurance contracts:

    (a) Direct insurance contracts that the entity holds. The boards decided tentatively not to carry out any further discussion on non-reinsurance policyholder accounting before issuing an exposure draft (however, reinsurance contracts held by cedants will be in scope).

(b) In their project on revenue recognition, the boards noted that some warranties are issued for short coverage periods to cover any defects that were undetected during the manufacture of the product. The staff believes that these warranties do not meet the definition of an insurance contract. That conclusion removes the need for the scope exclusion currently in IFRS 4 for product warranties issued directly by a manufacturer, dealer or retailer.

Structure of the Paper

4. The rest of this paper is divided into the following sections:

   (a) Background (paragraphs 7 through 8)

   (b) Scope of IFRS 4 (paragraphs 9 through 29)

      (i) Warranties (paragraphs 15 through 17)

      (ii) Fixed-fee service contracts (paragraphs 18 through 25)

      (iii) Residual value guarantees (paragraphs 26 through 27)

5. This paper does not discuss whether:

   (a) financial guarantee contracts should be in the scope of the future insurance contracts standard;

   (b) health contracts should be within the scope (that is, contracts that are issued by a non-insurance entity (such as a hospital or physician's group).

   Staff will bring a separate paper on these scope considerations for a future meeting.

6. Furthermore, this paper does not address scope considerations on investment contracts that contain discretionary participating features. Staff will bring this issue back when the boards discuss how to account for participating features.

Background

7. The IASB had received feedback from constituents during the deliberations for IFRS 4 which generally supported the scope of IFRS 4 (see Agenda Paper 6A ,FASB Memorandum No. 41A) for a discussion about the definition of an insurance contract). In the light of those responses, and responses to the IASB's discussion paper *Preliminary Views in Insurance Contracts*, the staff concluded that the IASB's existing definition of insurance contracts was unlikely to require significant reworking.

8. The staff also points out the following related issues:

    (a) The accounting for financial instruments (AFI) project team is drafting a memorandum that will address the scope of that project. At present, insurance contracts are excluded from that project. However, the scope of the AFI project may or may not include contracts similar to insurance contracts (such as financial guarantees) that could potentially meet the definition of an insurance contract pursuant to IFRS 4. An additional issue is that the IASB and FASB have not reached converged decisions to date in the AFI project.

    (b) IFRS 4 was written in the context of the existing structure of international standards and does not consider the U.S. GAAP guidance. U.S. GAAP provides specific guidance for contracts that are not considered insurance contracts or financial instruments (such as warranties and guarantees). Additional work will be necessary to appropriately integrate the proposed new guidance into the existing accounting literature. This exercise may result in the scope section being significantly different between the IASB and the FASB.

Scope of IFRS 4

9. The scope of IFRS 4 (paragraphs 2–6) states:

    2 An entity shall apply this IFRS to:

    (a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds.

    (b) financial instruments that it issues with a discretionary participation feature (see paragraph 35). IFRS 7 *Financial*

Instruments: Disclosures requires disclosure about financial instruments, including financial instruments that contain such features.

3 This IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see *IAS 32 Financial Instruments: Presentation*, *IAS 39 Financial Instruments: Recognition and Measurement* and IFRS 7), except in the transitional provisions in paragraph 45.

4 An entity shall not apply this IFRS to:

(a) Product warranties issued directly by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

(b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see *IAS 26 Accounting and Reporting by Retirement Benefit Plans*).

(c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets*).

(d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either IAS 39, IAS 32 and IFRS 7 or this Standard to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(e) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*).

(f) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder). However, a cedant shall apply this IFRS to reinsurance contracts that it holds.

5 For ease of reference, this IFRS describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

6 A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

10. Agenda Paper 6A (FASB Memorandum No. 41A) provides a detailed comparison of the IFRS 4 definition of an insurance contract with relevant material in U.S. GAAP. However, the staff has provided the definition of an insurance contract

from IFRS 4 for reference:

> A contract under which one party (the **insurer**) accepts significant **insurance risk** from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.

11. One key difference from U.S. GAAP is that the definition of an insurance contract in IFRS 4 (and, therefore, scope) is at the contract level. Any contract that meets this definition is accounted for under IFRS 4, regardless of the entity that issued it. However, IFRS 4 currently makes a number of scope exceptions; the scope section of IFRS 4 is included in paragraph 9.

12. Under U.S. GAAP, insurance accounting is applied based on the type of entity issuing the contract (see Topic 944 of the Accounting Standards Codification for a list of typical types of insurance entities). Therefore, if a bank were to issue the same contract as an insurance entity, they would use different accounting for that contract under U.S. GAAP (the guidance for banks differs from the accounting guidance for insurance companies).

13. Staff believes the following exceptions in IFRS 4 should be brought forward; we do not consider these items in detail in this paper:

    (a) employers' assets and liabilities under employee benefit plans, as well as retirement benefit obligations reported by defined benefit retirement plans. These assets and liabilities are accounted for under the relevant standards on employee benefits.

    (b) contingent consideration payable or receivable in a business combination, which are accounted for under the business combinations standards.

14. The following scoping items are worth highlighting for the boards' further consideration:

    (a) Warranties

    (b) Fixed-fee service contracts

    (c) Residual value guarantees

Warranties

15. IFRS 4 takes the position that all product warranties meet the definition of an insurance contract, but distinguishes two categories:

    (a) Product warranties issued by another party for goods sold by a manufacturer, dealer or retailer are within the scope of IFRS 4.

    (b) Product warranties issued directly by a manufacturer, dealer or retailer are outside the scope of IFRS 4.

16. The boards recently discussed warranties in the revenue recognition project and also identified two categories of warranties:

    (a) warranties for short coverage periods to cover any defects that were undetected during the manufacture of the product ("quality assurance" warranties). These do not meet the definition of an insurance contract because they are intended to ensure that the seller satisfies the performance obligation, they do not provide compensation for an uncertain future event.

    (b) warranties that provide coverage for the customer for faults that arise after the product is transferred to the customer. These warranties generally are issued by an unrelated third party outside of the sale of the product ("insurance" warranties). These do meet the definition of an insurance contract.

17. The staff believes the boards' analysis in the revenue recognition project is more appropriate than the analysis in IFRS 4 and supports that more recent analysis. The staff has identified no reason to scope the "insurance" warranties out of the standard on insurance contracts.

Fixed-fee service contracts

18. One type of contract that historically had not been considered insurance is fixed-fee service contracts in which the level of service depends on an uncertain event. Examples of such contracts include maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction and roadside assistance programs. Under both contracts, a fixed fee is based on an expected amount of occurrences but there is uncertainty surrounding whether or when a

repair or assistance is needed. In addition, the owner is adversely affected by the occurrence and the servicer compensates the owner. Therefore, such contracts meet the definition of an insurance contract.

19. IFRS 4 currently explains that applying that standard to such contracts is likely to be no more burdensome than applying the standards that would be applicable if such contracts were outside the scope of IFRS 4. Staff believes that this may change under the proposed building block model for insurance contracts:

    (a) IFRS 4 currently permits entities issuing insurance contracts to continue applying most aspects of their existing accounting models. However, this would change once we require a particular approach for insurance contracts.

    (b) If the service provider were to apply the model proposed in the boards' revenue recognition project, it would recognise revenue as it performs under the contract. However, the insurance model contract requires the service provider to apply a current measurement using the proposed building blocks.

    (c) The proposed disclosure requirements for insurance contracts may differ from those required for other contracts

20. Some types of fixed-fee service contracts are more likely to be subject to significant changes in circumstances, for example long-term maintenance contracts. For those fixed-fee service contracts the proposed building block model would produce useful information about future cash flows and changes in those cash flows.

21. However, other types of fixed-fee service contracts provide services over a relatively short period. And typically there are unlikely to be material liabilities for malfunctions and breakdowns that have already occurred. It seems unnecessarily burdensome to apply the building block model to those short-duration service contracts.

22. However, the boards are considering whether to apply a simplified measurement as part of their insurance model for broadly short-duration contracts. [The IASB tentatively decided to require a simplified measure, but FASB has not completed its discussion on this topic.] If a simplified measurement were to be applied, it would provide a measure that is obtainable with less cost and effort. This would also take away some of the potential burden of applying the insurance model to short-

duration fixed-fee service contracts.

23. Some may still be concerned with the fact that, even though a simplified measurement may be applicable, providers of service contracts would have to accustom themselves to the insurance contracts guidance and apply to those short-duration service contracts, given that much of that guidance will be written for much more complex circumstances. However, some of those concerns may be mitigated if the insurance model contains a simplified measurement approach for some of these contracts. Furthermore, some of those service providers may write long-duration service contracts and would have to accustom themselves to the insurance guidance anyway.

24. Another approach would be to scope some fixed-fee service contracts out of the insurance standard. One possibility is to draw a distinction along the lines of short-duration versus long durations. Another possibility is to make a distinction between cases where the service is provided by the party that also sold the goods versus a third party providing those services. However, drawing such a line for scoping purposes may result in a situation that similar contracts are treated differently, or that one service provider accounts for some service contracts under the insurance standard and other service contracts under another standard (the revenue recognition standard).

25. Staff therefore recommends that those service contracts that meet the definition of an insurance contracts (fixed-fee service contracts) remain in the scope of the forthcoming exposure draft on insurance contracts. We will update this recommendation after the boards have concluded their discussions on the application of a simplified measurement approach.

Residual value guarantees

26. Residual value guarantees embedded in a lease are not in the scope of IFRS 4. The boards are addressing residual value guarantees issued under a lease as part of their project on Leases. Accordingly, we propose that residual value guarantees under a lease are to be scoped out from the future insurance standard.

27. In the United States, residual value guarantee insurance is often provided by large insurance entities (representing a small part of their overall business). At least one entity that specializes in this type of insurance is regulated as an insurance entity

pursuant to the insurance laws of each state it is licensed in. Since the scope exclusion in IFRS 4 does not apply to stand-alone residual value guarantees, multi-line insurance entities would be required to apply the insurance contracts model to a residual value guarantee insurance contract. The staff believes that is appropriate.

Staff recommendation

28. The staff recommends that the following contracts should be excluded from the scope of the forthcoming exposure draft on insurance contracts:

    (a) residual value guarantees embedded in a lease;

    (b) employers' assets and liabilities under employee benefit plans and retirement benefit obligations reported by defined benefit retirement plans;

    (c) contingent consideration payable or receivable in a business combination.

29. The staff will present scope considerations on financial guarantee contracts, investment contracts with participating features, and health contracts separately, outside this paper.

Question for the boards
Do the boards agree with the staff recommendation in paragraph 28?